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Before the

TENNESSEE REGULATORY AUTHORITY

IN RE:

BELLSOUTH TELECOMMUNICATIONS, INC., CITIZENS
COMMUNICATIONS, INC., UNITED TELEPHONE-SOUTHEAST, INC.
PETITION FOR EXEMPTION OF CERTAIN SERVICES

DOCKET NO. 03-00391

DIRECT TESTIMONY
OF
STEVE BROWN

October 4, 2004

I. Introduction

Q_1. Please state your name.

A_1. Steve Brown.

Q_2. What is your job title and where do you work?

A_2. I am an Economist in the Consumer Advocate and Protection Division (CAPD), Office of the Attorney General.

Q_3. What are your responsibilities as an Economist?

A_3. I review regulated companies' petitions for rate changes in Tennessee and follow the economic conditions that affect the companies regulated by the Tennessee Regulatory Authority (TRA).

Q_4. What experience do you have regarding regulated utilities?

A_4. In 1995 I began work as an economist in the Consumer Advocate and Protection Division (CAPD) of the Attorney General's Office. I have appeared as a witness and filed testimony for CAPD in several dockets before the TRA. From 1986 to 1995 I was employed by the Iowa Utilities Board as Chief of the Bureau of Energy Efficiency, Auditing and Research, and Utility Specialist and State Liaison Officer to the U.S. Nuclear Regulatory Commission. From 1984 to 1986 I worked for Houston Lighting & Power as Supervisor of Rate Design. From 1982 to 1984 I worked for Arizona

1 Electric Power Cooperative as a Rate Analyst.
2 From 1979 to 1982 I worked for Tri-State
3 Generation and Transmission Association as
4 Power Requirements Supervisor and Rate
5 Specialist. Since 1979 my work spanned many
6 issues including cost of service studies, rate
7 design issues, telecommunications issues and
8 matters related to the disposal of nuclear
9 waste.

10
11 **Q_5. What is your educational background?**

12
13 **A_5.** I have an M.S. in Economics from the
14 University of Wyoming, an M.A. and Ph.D. in
15 International Relations with a specialty in
16 International Economics from the University of
17 Denver, and a B.A. from Colorado State
18 University.

19
20 **Q_6. What were you asked to do with respect to this**
21 **case?**

22
23 **A_6.** I was asked to form two opinions with respect
24 to this case:

- 25
26 • whether the petition to deregulate Primary
27 Rate ISDN service (PRI) service should be
28 evaluated in terms of the critical role
29 PRI plays in making voice-over-the-
30 internet (VOIP) an alternative to Plain
31 Old Telephone Service (POTs).

32
33 And
34

- whether potential and existing competition is an effective regulator of the price of PRI offered by BellSouth Telecommunications (BellSouth), United Telephone-Southeast, Inc. (UTSE), and Citizens Telecommunications Company of Tennessee (Citizens);

II. The Petitioner's Request To Deregulate PRI Is A Strategic Response To Deter VOIP in Tennessee.

Q_7. In your opinion should the petition to deregulate PRI service be evaluated in terms of VOIP being an alternative to POTS?

A_7. Yes. In my opinion the petition should be evaluated in terms of the critical role PRI plays in making VOIP an alternative POTS.

Attached to my testimony is a copy of a news story published in April 2004. The attachment is three pages long and discusses a Standard & Poor's report that ISDN PRI is being used to implement VOIP and that incumbent telephone companies may lose \$5 billion dollars annually if VOIP is substituted for POTS, as indicated by the highlighted portions on page 1 of the attachment:

"S&P says RBOCs stand to lose about \$5 billion in annual revenues if regulators makes [VOIP]..exempt from federal and state access fees.."

And

1 *"The overall loss could be mitigated by VOIP providers'*
2 *recurring payments to RBOCs for local connectivity such as ISDN*
3 *primary rate interface[emphasis added by CAPD] or toll-free 800*
4 *service. On the other hand, the loss could soar beyond \$5 billion if*
5 *VOIP providers use leased facilities to terminate large volumes of*
6 *long-distance calls"*

7
8 Although BellSouth's PRI petition was filed
9 with the TRA on June 16, 2003, nearly four
10 months earlier BellSouth had explained VOIP's
11 threat to POTs. On February 23, 2003 BellSouth
12 and SBC filed joint comments with the FCC
13 confirming the competitive threat of VOIP to
14 incumbent telephone companies:

15
16 *" Moreover, providers are increasingly offering IP telephony*
17 *services that they claim are exempt from regulation as a*
18 *telecommunications service, including the obligation to contribute*
19 *to universal service. The migration of end users to broadband*
20 *services that are not included in the contribution base also*
21 *continued to accelerate during the past year. These market trends*
22 *are inevitable and irreversible."*

23
24 And

25
26 *"The Commission's interim revenue-based methodology does*
27 *nothing to reverse the rapid erosion of the universal service*
28 *contribution base that is being caused by the proliferation of IP*
29 *telephony services and broadband services that are not included in*
30 *the current contribution base. [JOINT COMMENTS OF SBC*
31 *COMMUNICATIONS INC. AND BELL SOUTH CORPORATION,*
32 *pages 4, 5 at FCC website:*
33 *[http://gulfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&](http://gulfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6513583395)*
34 *[id_document=6513583395](http://gulfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6513583395)*

35
36
37 Furthermore, the Chairman of the FCC said in
38 regard to VOIP:
39
40

1 *"Today, we begin an important process which should have as its*
2 *goal the empowerment of consumers and entrepreneurs. As one*
3 *who believes unflinchingly in maintaining an Internet free from*
4 *government regulation, I believe that IP-based services such as*
5 *VOIP should evolve in a regulation-free zone. No regulator, either*
6 *federal or state, should tread into this area without an absolutely*
7 *compelling justification for doing so."* [Opening Remarks of FCC
8 Chairman Michael K. Powell At the FCC Forum on Voice over
9 Internet Protocol (VOIP) December 1, 2003 Washington D C at
10 the FCC Website.

11 [http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-241775A1.pdf)
12 241775A1.pdf.]
13
14

15 The news story attached to my testimony, and
16 the statements by BellSouth and FCC Chairman
17 Powell make clear that the way ISDN PRI has
18 been used in the past in Tennessee is not
19 necessarily representative of the future use
20 of ISDN PRI, which has all the appearance of
21 being a platform for VOIP. Therefore, it is
22 reasonable to see the petitioners request to
23 deregulate PRI as a strategic effort in
24 Tennessee to counter the use of PRI as a
25 platform for VOIP, a service that would
26 directly compete with the petitioners' bread-
27 and-butter service, POTs.
28

29 Also, all the PRI CSAs referenced in Terry
30 Buckner's testimony, and the declining prices
31 in those CSAs, are not indications that the
32 PRI markets in Tennessee are, were, or will be
33 competitive. Those PRI CSAs are representative
34 of a dominant provider whose strategy is to
35 improve market share by reducing prices.
36

37 For example, in its SEC Form 10-K of 2002
38 BellSouth stated that its strategy was in
39 general to improve market share in all
40 services:

1 *"Our business strategy is to solidify BellSouth as the leading*
 2 *choice of customers in the southeast for an expanding array of*
 3 *voice, data and Internet services and to meet our customers'*
 4 *national needs through teaming or wholesale service*
 5 *arrangements with other companies*

6
 7 *Specifically, we intend to. :*

8
 9 • *optimize our portfolio of products and services by utilizing*
 10 *marketing approaches targeted to our different customer segments,*
 11 *superior service and marketing strength to grow our market share*
 12 *[emphasis added by CAPD] by offering packages of voice, data*
 13 *and multimedia applications through improved distribution*
 14 *channels and systems."* [BELLSOUTH CORP SEC Form 10-K 405
 15 *filed 2002/02/28, page 5.]*

16
 17
 18 Thus far PRI CSAs have not been a platform for
 19 IP telephony services that compete with
 20 BellSouth's, USTE's and Citizens' traditional
 21 service, POTs. But in the future BellSouth,
 22 UTSE and Citizens are not likely to offer CSAs
 23 for PRI where it enables VOIP to challenge
 24 POTs.

25
 26 Therefore, deregulating PRI would allow
 27 BellSouth, UTSE and Citizens to price
 28 discriminate among PRI customers according to
 29 how the service is used. PRI customers who
 30 offer VOIP could pay very high prices for PRI
 31 while PRI customers who do not offer VOIP
 32 could pay very low prices. Of course PRI price
 33 discrimination is carried out now, as Terry
 34 Bucker's testimony proves.

1 However, with tariffs and regulation in place
2 the price discrimination is limited in the
3 sense that there is a price-ceiling on PRI: no
4 PRI customer pays more than the charges stated
5 in the tariff. This fact highlights the only
6 pricing-benefit that would accrue to the
7 petitioners if the TRA were to grant their
8 request: at their own discretion, the
9 petitioners would be free to set PRI prices
10 without regard to current regulatory and
11 tariffing requirements. Therefore, there would
12 be no price-ceiling on PRI services. This
13 result would deter or prevent the deployment
14 of VOIP in Tennessee.

15
16 **Q_8.** **In your opinion, have the petitioners offered**
17 **an "an absolutely compelling justification" for**
18 **the deregulation of PRI pricing in Tennessee?**
19

20 **A_8.** No. In my opinion the petitioners have not
21 offered an "an absolutely compelling
22 justification" for the deregulation of PRI
23 pricing in Tennessee. Despite their full
24 knowledge of the FCC's efforts to forge a
25 national policy on VOIP and their full
26 knowledge that PRI is essential to VOIP, their
27 petition is silent on these issues. Their
28 petition does not disclose the broader context
29 of a new technology challenging POTS and the
30 already on-going efforts of the FCC to forge a
31 national policy on this issue.

III. The Dominant Firm Model Must Be Used To Evaluate Whether Potential And Existing Competition Is An Effective Regulator Of The Price Of PRI.

Q_9. In your opinion what analytical tool must be used to evaluate whether potential and existing competition is an effective regulator of the price of PRI?

A_9. In my opinion the analytical tool is the "dominant firm" model.

Q_10. What is the "dominant firm" model?

A_10. The "dominant firm" model is a well known means of analysis employed by the Federal Trade Commission and the FCC to analyze the effects market share on prices and on a firm's competitive behavior.

With regard to PRI services, the dominant firm model says that a firm raises PRI prices because rival firms do not have the capacity to accommodate customers who want to switch PRI providers in response to the dominate provider's price-increases. The remedy calls for rival firms to expand their facilities and raise PRI capacity. If the expansion of capacity is large enough and accomplished in a sufficiently short period of time, then the market power of the dominant firm will be constrained. This expansion is central to determining that "potential" competition will

effectively regulate PRI prices in the relevant market.

Q_11. In your opinion is the dominant firm model consistent with the pricing-benefit that would accrue to the petitioners if the TRA were to grant their request?

A_11. Yes. My opinion is that dominant firm model is consistent with the pricing-benefit that would accrue to the petitioners.

For example, I have already testified that the advantage of PRI deregulation is to allow the petitioners to raise their PRI prices above price-ceilings for PRI services. The dominant firm model is aimed specifically at evaluating situations where the dominant firm positions itself to raise prices.

Q_12. In your opinion is BellSouth the dominant provider of PRI services?

A_12. Yes. In my opinion BellSouth is the dominant provider of PRI services, as Terry Buckner's testimony proves.

Q_13. In your opinion what facts must be known to implement the dominant firm model?

A_13. In my opinion there are several facts that must be known:

- there must be a definition of the relevant markets for PRI services for BellSouth;
- there must be a definition of the relevant markets for PRI services for UTSE;

- 1 • there must be a definition of the relevant
2 markets for PRI services for Citizens;
3
- 4 • within the relevant markets for
5 BellSouth's PRI service, there must be
6 reliable data showing each provider's
7 share of the market for each month of the
8 past 24 months;
9
- 10 • within the relevant markets for UTSE's PRI
11 service, there must be reliable data
12 showing each provider's share of the
13 market for each month of the past 24
14 months;
15
- 16 • within the relevant markets for Citizens'
17 PRI service, there must be reliable data
18 showing each provider's share of the
19 market for each month of the past 24
20 months;
21
- 22 • within the relevant markets for
23 BellSouth's PRI service, there must be
24 reliable data showing the expected rate at
25 which competitors could expand their PRI
26 capacity in response to BellSouth's PRI
27 pricing over the next 24 months;
28
- 29 • within the relevant markets for UTSE's PRI
30 service, there must be reliable data
31 showing the expected rate at which
32 competitors could expand their PRI
33 capacity in response to UTSE's PRI pricing
34 over the next 24 months;
35

- within the relevant markets for Citizens' PRI service, there must be reliable data showing the expected rate at which competitors could expand their PRI capacity in response to Citizens' PRI pricing over the next 24 months;

Q_14. In your opinion has the petitioner provided the data you just described?

A_14. No. In my opinion the petitioners have not provided such data.

Q_15. Has the FCC recently used the dominant firm model?

A_15. Yes. The FCC recently used the dominant firm model in its decision to lift certain restrictions from AOL-Time Warner in the use of AOL's Instant Messaging service, in docket CS-00-30.

Q_16. Did any of the petitioners comment in that FCC case?

A_16. Yes. BellSouth filed reply comments in that case.

Q_17. Did BellSouth's comments acknowledge the dominant firm model?

A_17. Yes. For example, BellSouth commented on AOL's dominant position:

1 *" ..it is important to 'follow the money' in analyzing most matters,*
2 *and this is no exception....If AOL is permitted to leverage its*
3 *dominant network position ..AOL could act anti-*
4 *competitively . "[BELLSOUTH REPLY COMMENTS, pages 5,7*
5 *In FCC Cable Services Bureau Docket 00-30at the FCC Website:*
6 *[http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&](http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6514132050)*
7 *[id_document=6514132050](http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6514132050)]*
8

9 Q_18. In your opinion have the petitioners shown
10 that potential and existing competition is
11 an effective regulator of the price of PRI
12 in Tennessee?
13

14 A_18. No. In my opinion the petitioners have not
15 shown that potential and existing
16 competition is an effective regulator of
17 the price of PRI in Tennessee.
18

19
20 This concludes my testimony at this time.
21

Docket No 03-00391
Exhibit CAPD-SB
Direct Testimony
Attachment To Direct
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S&P Cautions Bells on VOIP

A broad warning issued last week by credit rating service Standard & Poor's has cast a lingering dark cloud over regional Bell companies (RBOCs). It's also raised new questions about VOIP regulation.

S&P says RBOCs stand to lose about \$5 billion in annual revenues if regulators make voice-over-IP providers exempt from federal and state access fees. RBOCs currently rely on carrier access fees for about 22 percent of their total operating revenues, or about \$20 billion.

In its estimate, S&P assumed RBOCs will lose about 15 percent of residential access lines with average monthly bills of \$24 each to cable companies, independent carriers, and long-haul carriers that offer VOIP service. Loss of local lines would account for about four-fifths of the \$5 billion shortfall, and loss of access fees would make up the rest.

The overall loss could be mitigated by VOIP providers' recurring payments to RBOCs for local connectivity services such as ISDN primary rate interface or toll-free 800 service. On the other hand, the loss could soar beyond \$5 billion if VOIP providers use leased facilities to terminate large volumes of long-distance calls.

The issue hinges partly on whether the Federal Communications Commission (FCC), states, and courts require VOIP carriers to pay access fees to RBOCs for VOIP traffic transmitted over, or terminated on, the RBOCs' networks.

Current regulation of VOIP service is murky at best. VOIP providers like Vonage Holdings Corp. and AT&T Corp. (NYSE T - [message board](#)) have claimed that they are information services and should not be treated as telecommunication services, which are required to pay access fees. Some state regulators, such as the Minnesota Public Service Commission, have challenged those claims. But in October, a U.S. District Court overruled Minnesota's decision to regulate Vonage as a telecom carrier.

The FCC is reviewing VOIP regulation but has no deadline for a definitive decision. Whatever it decides, the threat of VOIP to the RBOCs may be unavoidable. "Regardless of what happens with regulation, I think you'll see the competition [from VOIP providers] move forward," says Catherine Cosentino, the credit analyst at S&P who wrote the report.

S&P currently has a credit watch on all three investment-grade RBOCs: SBC Communications Inc. (NYSE SBC - [message board](#)), BellSouth Corp. (NYSE BLS - [message board](#)), and Verizon Communications Inc. (NYSE VZ - [message board](#)). But Cosentino stresses that the threat from VOIP providers is only one of several reasons for the rating service's concern. Substitution of cell phones for wire lines also puts RBOCs' revenues at risk, as does the loss of retail lines to unbundled network element platform (UNE-P) competitors.

Some RBOCs, such as Verizon, have been battling S&P's negative view. When S&P

- Wl
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put Verizon on credit-watch negative, Verizon release (see [Verizon Scuffles With S&P](#) and

Docket No 03-00391
Exhibit CAPD-SB_____
Direct Testimony_____
Attachment To Direct
Page 2 of 3_____

But VOIP is poised to grow quickly, especially last year, Cablevision Systems Corp. (NYSE [CVC](#) - [message board](#)) rolled out VOIP service and had 29,000 subscribers by Dec 31, 2003. [Cox Communications Inc.](#) (NYSE [COX](#) - [message board](#)), Time Warner Cable, and Comcast Corp. (Nasdaq. CMCSA, CMCSK) have introduced similar offerings

In response, some RBOCs have started deploying VOIP service themselves. Qwest Communications International Inc. (NYSE [Q](#) - [message board](#)) provides the service to consumers in Minnesota, and SBC offers VOIP to business customers as part of an Internet services package.

VOIP systems can be as much as 50 percent less expensive for RBOCs to maintain than circuit-switched systems. Nevertheless, RBOCs may still have to cut prices for VOIP services to compete with CLECs, which have lower overall cost structures.

— Justin Hibbard, Senior Editor, *Light Reading*

Article Talk

ID	Subject	Author	Date
282	Re: VoIP To tax or not to tax	aswath	4/30/2004 10:55:37 PM
281	Re: VoIP To tax or not to tax	technonerd	4/30/2004 9:54:20 PM
280	Re: VoIP To tax or not to tax	aswath	4/30/2004 9:14:38 PM
279	Re: VoIP To tax or not to tax	technonerd	4/30/2004 5:52:25 PM
278	Re: VoIP To tax or not to tax	technonerd	4/30/2004 5:43:08 PM
277	Re: VoIP To tax or not to tax	aswath	4/30/2004 10:23:51 AM
276	Re: VoIP To tax or not to tax	technoboy	4/29/2004 10:31:15 PM
275	Re: Packet8/Vonage Biz Case?	technoboy	4/29/2004 10:26:47 PM
274	Re: VoIP To tax or not to tax	technonerd	4/29/2004 6:52:05 PM
273	Re: Question Re: VoIP To tax or not to tax	technonerd	4/29/2004 6:50:30 PM
272	Re: Packet8/Vonage Biz Case?	technonerd	4/29/2004 6:47:46 PM
271	Re: VoIP To tax or not to tax	technoboy	4/29/2004 6:46:11 PM
270	Question Re: VoIP To tax or not to tax	rjs	4/29/2004 6:45:51 PM
269	Re: Packet8/Vonage Biz Case?	technoboy	4/29/2004 6:38:02 PM
268	Re: VoIP To tax or not to tax	stephenpcooke	4/29/2004 4:22:14 PM
267	Re: Packet8/Vonage Biz Case?	technoboy	4/29/2004 2:29:34 PM

[267 Re Packet8/Vonage Biz Case](#)

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Before the

TENNESSEE REGULATORY AUTHORITY

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COMMUNICATIONS, INC., UNITED TELEPHONE-SOUTHEAST, INC.
PETITION FOR EXEMPTION OF CERTAIN SERVICES**

DOCKET NO. 03-00391

AFFIDAVIT

I, Steve Brown, for the Consumer Advocate and Protection Division of the Attorney General's Office, hereby certify that the attached Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate and Protection Division.

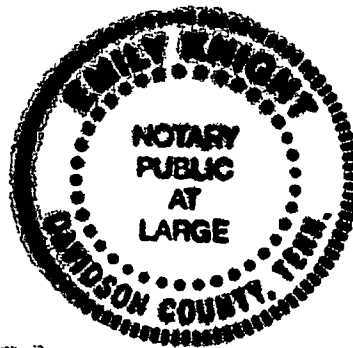

STEVE BROWN
Economist

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